

Funding additional infrastructure – who picks up the bill?

Beijing wants to ramp up infrastructure investment to help the economy. The question is, how will this investment be funded?

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Key takeaways

- Our analysis suggests that China's authorities have two options: They can fund the additional investment using the policy banks or by issuing special treasury bonds.
- The central bank (PBoC) has already signaled that policy banks will have a bigger role in funding infrastructure investment this year, and we expect the PBoC to provide the policy banks with cheap funding using its pledged supplementary lending (PSL) facility, which is exclusively used to fund central government priorities.
- Using policy banks and the PSL in tandem would help Beijing stimulate struggling provinces by providing them with cheap credit for new projects.
- However, unless the policy banks come up with a creative way to structure the loans, the debt burden could fall on local governments, which are increasingly ill-equipped to take on additional borrowing.
- Alternatively, the central government could resort to issuing special treasury bonds, which would get around the local government debt problem – because the central government would take on the debt burden directly.
- The central government last used special treasury bonds in 2020, issuing RMB 1 trillion worth to fund COVID-19 relief and pandemic-related infrastructure construction.
- However, Beijing might be reluctant to use special treasury bonds for a broad-based infrastructure program because it means central government debt is used to stimulate regional economies – something the government has traditionally avoided.
- Importantly, these two approaches aren't mutually exclusive and could be used in tandem. However, before either is deployed, China's authorities need to make some political decisions about how the funding burden should be allocated between central, provincial, and lower-level authorities.

Xi Jinping wants to ramp up infrastructure investment to help boost the flailing economy. The question is, how will this investment be funded?

It's no idle question. The central government's 2022 budget made only marginal provisions for increased infrastructure spending this year, and Beijing may be reluctant to approve an additional quota of special-purpose bonds (SPBs) – the primary tools for funding public works – for reasons we outline below.

We see two other potential courses of action available to Beijing:

- China's policy banks could ramp up lending to infrastructure projects – and do so at low interest rates – by borrowing from the central bank's (PBoC) pledged supplementary lending (PSL) facility.
- The central government could issue special treasury bonds, and use the funds for infrastructure investment.

Both approaches could facilitate a massive increase in funding – upwards of RMB 1 trillion if precedent is anything to go by – for Beijing's infrastructure priorities. What's more, the approaches aren't mutually exclusive – Beijing could conceivably deploy both. But the burden of funding under each approach falls on different parties, which is something Beijing needs to consider when deciding how to proceed.

This report discusses these two options, and what they could mean for Beijing's efforts to prop up the economy.

The funding gap

In the last week of April, the Central Commission for Financial and Economic Affairs (CCFEA), chaired by Xi Jinping, called for an increase in infrastructure investment to support China's flagging economy. It wasn't a total surprise. Over the last couple of months, various government agencies have published lists of investment priorities, including highways, water conservancy projects, pipe networks for urban utilities, data centers, and renewable energy. Central authorities haven't indicated how much more investment will be necessary, but such spending would need to see a significant boost above current levels to offset slowing property sector investment and weak consumption – especially as officials remain committed to hitting their overly ambitious “around 5.5%” GDP growth target for the year.

In recent years, the issuance of SPBs by local governments has been the main source of fiscal funds for infrastructure projects. The SPB quota for this year was set at RMB 3.65 trillion, the same level as last year – and a clear indication that policymakers didn't initially anticipate a need for stimulus in 2022. That said, RMB 1.2 billion worth of the SPBs issued last year wasn't spent, increasing the volume of funds available for 2022. Still, at this point it's clear that even this additional amount won't be sufficient to buoy growth, given the ever-increasing headwinds facing China's economy right now.

Of course, the central government could roll out an additional SPB quota. But that seems unlikely. Beijing introduced the 2022 SPB quota at the National People's Congress in March. Increasing it so soon after announcing the initial quota would look like a massive planning failure

– which it undoubtedly is – and, even worse, like the government is in panic mode.

What's more, Beijing may not know just how much additional credit it actually needs to deploy. Ideally, it needs a tool that would allow it to increase credit as required without committing to a number upfront. An additional SPB quota commits Beijing to deploying a certain amount of new credit, which could cause the authorities major embarrassment if it proves to be insufficient. That's why we suspect that officials will use the policy banks to drive infrastructure investment.

Pledged supplementary lending

The PBoC has already flagged that the policy banks – China Development Bank, Export-Import Bank of China, and Agricultural Development Bank of China – are set to play a role in supporting infrastructure investment this year. Among the slate of 23 economic support measures the PBoC rolled out on April 18, one included the idea that:

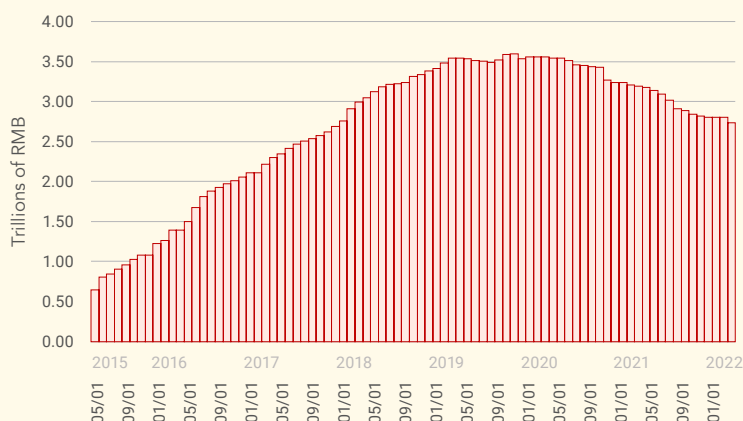
“Development and policy banks should increase their financial support for key investment projects”

The policy banks mainly fund themselves by issuing bonds. But in certain circumstances, they have access to an even cheaper form of funding – the Pledged Supplementary Lending (PSL) facility.

The PSL facility is one of the PBoC's many lending windows, albeit reserved exclusively for policy banks. Under the PSL, the PBoC makes collateralized loans used exclusively to fund central government priorities.

The PSL was previously deployed to support China's property market by funding slum redevelopment. Between mid-2015 and end-2019, the PBoC lent out almost RMB 3 trillion under the facility [Fig. 1]. However, the PBoC has been winding back the PSL program since early 2020, with the total amount of funds outstanding declining by about RMB 800 billion from its peak.

Fig. 1 - Total outstanding funds under the PBoC's pledged supplementary lending (PSL) facility



Source: CEIC

The advantage of using policy banks to fund infrastructure is that Beijing can ensure that projects get built relatively cheaply in the places that need a boost. In contrast, investors demand a premium for purchasing SPBs issued by provinces with weak economies – pushing up costs in places that can ill afford it.

At this point, there's no way of knowing how much credit the PBoC could pump out through the PSL facility. The facility was most aggressively used in 2016 when the PBoC lent almost RMB 1 trillion to policy banks. Since then, the economy has expanded substantially, with total bank lending up 85%. That suggests the PBoC could easily lend between RMB 1.5 to 2 trillion via the PSL over the next 12 months.

To whom, and for what?

A potential constraint on Beijing's ability to ramp up infrastructure investment is the local governments. Local governments have traditionally borne most of the cost of funding public works, but their enthusiasm for taking on new construction projects has waned in recent years.

- In many parts of the country, local government finances are increasingly stretched. With many governments struggling to service debt raised to fund previous infrastructure projects, they're reluctant to take on more – not least because declining land sales have reduced the primary source of income used to pay down debt.
- Local authorities are most inclined to launch projects that will eventually pay for themselves. In fact, these are the only projects that central government agencies – namely the National Development and Reform Commission (NDRC) and the Ministry of Finance (MoF) – have been willing to approve in recent years. However, such projects are increasingly hard to find. Even if the NDRC and MoF relax their standards, local authorities might still be wary of taking on more debt for projects that can't become financially sustainable.

If the PBoC does deploy the PSL facility, then, the challenge will be finding projects that would otherwise not get built. The risk is that the policy banks cannibalize projects that would typically get funded by SPBs.

With this constraint in mind, the slum redevelopment program is an example of how the PSL can be stimulatory. After years of over-building, in 2015, the property sector was struggling with excess supply. Slum redevelopment was designed to create buyers for empty apartments by giving people living in slums the resources to buy new apartments. It worked like this:

- The PBoC lent to the policy banks. The policy banks then lent to local governments. Local governments then expropriated the land beneath urban slums and used the money from the policy banks to compensate people who had just lost their homes.
- The funds were placed in an escrow account that slum-dwellers could then use to pay for newly constructed housing. The funds then went directly to the developer that built the housing.
- The local governments made back the money they paid out to slum dwellers by clearing the slum and selling the land to developers.

The process bailed out the developers and breathed new life into the property market.

But how do the policy banks repeat the trick this time? This is where we run out of bright ideas. The special sauce of slum redevelopment – the key factor that made it work – was land sales. That's not going to fly this time around.

One conceivable approach is that the policy banks fund central government state-owned state enterprises (SOEs) with cheap, long-term loans to build infrastructure that eventually generates a consistent but low return. Or perhaps they'll fund SOEs from economically robust provinces like Zhejiang and Jiangsu to build infrastructure in poorer provinces. In both cases, the financial burden – which is minimized by preferential lending rates – ultimately would fall on governments that are better equipped to deal with additional debt.

Special treasury bonds

Alternatively, Beijing might decide to issue special treasury bonds as a way for the central government to take on the burden of funding infrastructure itself. From the central government's point of view, the beauty of special treasury bonds is that they're an off-budget device – they're a workaround that allows Beijing to raise additional debt without it counting toward the official budget deficit.

China last issued special treasury bonds in 2020 as part of its pandemic relief measures (before that, they were used in 2007 to capitalize China Investment Corp., China's sovereign wealth fund). RMB 1 trillion worth of bonds were issued across June and July 2020 – and that year, local authorities were instructed to accelerate their issuance of SPBs to before June, to ensure that the central and local government bonds weren't competing against each other for investors. The funds raised from the bonds' issuance were funneled through the provincial governments – which took a cut – to county and prefecture governments. The MoF oversaw the funds to ensure they were used either for infrastructure projects or COVID relief.

The MoF credits the bonds with:

“Addressing the infrastructure shortage in areas such as public health and environmental protection, actively encouraging public investments, and effectively driving economic growth”

The beauty of special treasury bonds is that they're a way of funding infrastructure without the financial burden falling disproportionately on local governments. However, Beijing has traditionally avoided stimulating local economies using central government debt, with the exception of 2020.

As yet, we haven't seen any concrete indication that Beijing is considering rolling out special treasury bonds for this purpose, but given China's current economic challenges and the recent use of such bonds to combat pandemic-driven economic weakness, it's undoubtedly an option.

The clock is ticking

Beijing unquestionably has the tools available to fund a big increase in infrastructure investment. The challenge is deciding how the funding burden should be allocated between central, provincial, and lower-level authorities. How the burden is distributed will also influence where the money gets spent.

These are complex political questions, but China's authorities are on a deadline. They are not only striving to deliver 5.5% growth by year-end, but they also want to have stabilized the economy before the Party congress this Fall. That means they need a coherent growth and investment strategy by the end of May, at the latest. The clock is ticking.